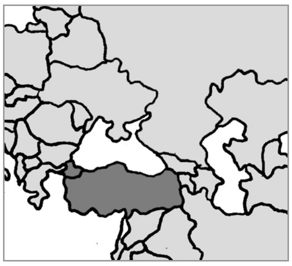

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Turkey:
a robust, but recessive economy

Turkey's GDP is likely to decline by 2-3% in 2009, mirroring exactly what the analysts have come to expect for the EU and the United States. In the case of Turkey, this means a remarkable change of scenery after several years of very high growth. At the outbreak of the international financial crisis, a business downturn was already in the making in Turkey; it is now intensifying to an unexpected degree. The Turkish banking sector is relatively robust thanks to earlier restructuring, regulation and surveillance in response to the homemade financial crisis in 2001. Nevertheless, the banks' risk awareness has increased; for households and non-financial corporations alike, this means tighter lending conditions and higher risk premia. The Central Bank's business climate survey points to historical lows in terms of both the current situation and people's expectations for the next few months. The companies complain about the lack of entries in their order books and capacity utilization is low.

The Central Bank's real sector confidence index in January stood at 55: down from 104 in the same month of the previous year. As for the first three months of the current year, only 16% of the companies expected an increase in output and less than 5% envisaged an upturn in employment. The purchasing managers' index as published by the Turkish Economy Bank fell to 31 in December 2008: a six-year low (an indicator lower than 50 means that industry is contracting). Even more pessimistic was the assessment of new orders coming in; the index plunged below 29. In December 2008, the rate of capacity utilization in manufacturing was a mere 65%[1]. The GDP had already contracted in the fourth quarter of 2008; the above figures suggest that in the first half of 2009 the recession will continue to deepen with no prospects of it being overcome in the short term. Owing to low capacity utilization, real sector investment over the next few months will remain confined to a certain measure of replacement and technological updating of current capacities.

In 2009, household consumption will decline. One reason is the decline in household borrowing, which became visible towards the end of 2008; another reason is the decline in employment and real income. Exports slumped badly during the final months of 2008, and a swift return to high volumes is unlikely. Imports are also falling for two reasons: lower world market prices (especially for energy) and lower import volumes. In recent years, Turkey has become an important producer and exporter of transport equipment; it is now suffering on account of the worldwide decline in demand for these products.

1 Provisional survey results of 4808 manufacturing industrial establishments weighted by production value according to NACE Rev. 1.1; the December 2007 figure had been 81% (Source: Turkish Statistical Institute).

In fiscal terms, Turkey's economy creates a relatively robust impression. Thanks to a series of high annual primary surpluses and debt growing less than the GDP, the general government's debt to GDP ratio dropped to 38.1% (June 2008). Local elections, scheduled for March 2009, will put the popularity of the ruling Justice and Development Party[2] to the test. Only thereafter, will negotiations with the IMF most likely lead to a new stand-by agreement; it is expected to be for a period of 18-24 months and foresees financial support of the order of EUR 15-20 billion. Turkey would be in a much better position today, had a new stand-by agreement been concluded soon after the expiry of the previous agreement in May 2008.

It is neither the government nor the banking sector that could stir up major trouble. Foreign debt in the non-financial corporate sector has increased rapidly over the past few years, peaking at 25% of GDP in 2008 (compared to 16% in 2004). In the fourth quarter of 2008, the non-financial corporate sector drastically reduced its borrowing from abroad, and became, together with the banking sector, a net re-payer. For Turkey, debt servicing has not customarily been a problem. Last autumn, when the international financial crisis took on a new dimension, it had an impact on Turkey too. Nerves were strained, the currency dropped in value and interest rate spreads increased. Later on, however, the situation relaxed and the lira recouped some of its losses. In an endeavour to stimulate capital inflows, Turkey has tried to create conditions conducive to attracting Turkish money parked abroad, which is roughly estimated as possibly amounting to some EUR 100 billion. It has also tried selling bonds index-linked to the revenues of several state-owned companies so as to attract investors from the Gulf States. To date, both attempts have yielded but modest results. In January, it transpired that fears about debt affordability had been exaggerated. A USD 1 billion 2017 bond that Turkey issued in the first half of January was oversubscribed – by a factor of two. The yield spread over US treasuries was approximately 500 basis points and the yield to maturity 7.5%. Under current conditions, this has been perceived as a success, which will encourage the issue of more debt in the first half of 2009 as a means of replenishing the country's foreign currency reserves. Foreign direct investment (FDI) amounted to EUR 11 billion in 2008; it may reach about half that value this year. FDI is frequently linked to mergers and acquisitions (EUR 14.5 billion in 2009); these will also decline over the year.

Over the past few years, the current account deficit rose constantly and reached EUR 26 billion (or 4.7% of GDP) in 2008. The deficit in trade with goods amounted to EUR 32.5 billion and the surplus in services to EUR 11.5 billion. Turkey's exports of goods have diversified considerably over recent years in terms of both destination and composition; this means that the country is less dependent on what happens in individual partner countries. In recent months, Turkish exports to emerging markets have risen, whereas exports to others have declined. In the case of the automotive industry, however, the degree of diversification is low as Turkish cars are primarily shipped to EU countries. In late 2008, shipments dropped dramatically. In December 2008 the association of car manufacturers reported a decline of close on 60% year-on-year and stressed the need for a rescue package. Temporary production stoppages have become the rule and companies are cutting back on labour.

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2 Adalet ve Kalkınma Partisi AKP.

A major factor contributing to the current account deficit has been the scale of profits originating from foreign investment. In previous years, recipients used to re-invest a large proportion of their profits in Turkey. The overall inflow of foreign capital did not merely finance current account deficits, but it also led to a continuous increase in foreign currency reserves from 2001 onwards. At the end of 2009, those reserves amounted to EUR 51 billion. This was higher than it had been a year before despite some decline during the fourth quarter of the year. The current account deficit also fell in the final quarter of 2008.

Given the impact of skyrocketing prices on international energy markets, the rate of consumer and producer price inflation temporarily overshot the 10% mark in 2008. During the last quarter of the year, however, the price indices first stopped rising and then even declined at a later juncture. As a result, the rate of inflation for 2008 as a whole only slightly exceeded 10%. The consumer price index for 2009 may well plummet to some 8%; it could decline even more in the absence of lira devaluation. Some devaluation is, however, likely, but it may be less pronounced than predicted by Nomura International. Another source of inflation could be a lifting of the ceilings on regulated prices. For example, electricity prices are kept at a level, which is said to make investment in new capacities unprofitable. Turkey's producers of tradable goods and services can be assumed to be pleased to see the lira devalued somewhat, as that increases their competitiveness on both domestic and foreign markets. It does, on the other hand, spell trouble for those burdened with high debts denominated in foreign currency.

At the end of 2008, private companies held USD 99.3 billion in long-term foreign debt. Of this amount, USD 42.2 billion (USD 12 billion held by banks and USD 30.2 billion held by the non-financial private sector) will mature in 2009, with the highest proportion to be repaid in March, June and September-October.

Under the impact of the recession, government revenues did not come up to expectations in the fourth quarter of 2008. A large number of companies failed to pay the full amount of accrued tax. This will continue in 2009, despite measures designed to increase taxpayer (or rather non-taxpayer) discipline. The government stresses that much is being done to enhance the business climate: for example, through programmes amounting to about 1% of GDP in 2008; a higher proportion is envisaged for 2009. The programmes aim at improving the infrastructure (roads and water supplies), supporting the building of homes and making more funds available for local administration (wages and other expenditures). After the local elections in late March, there may be no room left for anti-cyclical fiscal policies. With or without the IMF agreement, the government may be forced to curb expenditures in response to the unsatisfactory development of revenues.

Durmuş Yılmaz, the governor of the Central Bank, opposes the demands that the government should launch a comprehensive stimulus package. Turkey's economy is not in a position to implement expansionary fiscal policies; this would result in higher interest rates and risk premia, so the governor's warning. In his view, it is the Central Bank that can do a lot of useful things and has done so already. The Central Bank adopted active liquidity measures so as to inject confidence into financial markets and will remain flexible in its approach to further measures. In order to relax the liquidity squeeze, the Central Bank cut interest rates, introduced foreign exchange auctions and/or re-established the foreign exchange depot market. Prime Minister Erdoğan accused the banking sector of slamming the door shut on the real economy. The response of Suzan Sabancı Dinçer, a member of the Akbank board, was that 'Turkish banks lend to those with credibility'. Banks are adopting a wait-and-see approach. In recent months, the share of non-performing loans has been on the rise; this comes as no surprise during a business slump. More consumers than before have had trouble servicing their debts, and the volume of non-performing credit card debt increased.

Without doubt, Turkey, too, is caught in the liquidity-trap. The Central Bank's lowering of interest rates does not mean that banks will re-intensify their lending activities. For Turkey as well, a change in external conditions will be the precondition for a return to high growth. The US economist Dani Rodrik recommends that the government put emphasis on: (i) helping corporations to meet their financing needs; and (ii) maintaining credit mechanisms through a type of collocation involving a guarantee fund. Turkey could well manage to weather the stormy months or years ahead without incurring a disaster. If that is the case, the current exchange rate might devaluate to a limited extent. Whether that means that the economy will then be predominantly stabilized or predominantly dynamic is anybody's guess.

Guiding the country into EU membership ranked high as a priority target during Mr. Erdoğan's early years as Prime Minister. In the meantime, any hopes of achieving rapid progress on that score have evaporated. Many people have lost all enthusiasm; the government now contents itself with keeping the accession process alive. It derives greater comfort from strengthening its ties with neighbouring countries. This policy has also proved quite successful in economic terms; it has contributed to boosting Turkish self-confidence. The Gaza conflict in late 2008 and early 2009, however, triggered considerable collateral damage in Turkey's foreign policy.

As for the development of the country's economy over the next few years, Turkish society is adept, accustomed to change and full of dynamism. As soon as the international business climate improves, economic growth will jump-start again. This moment, however, is not likely to come within a matter of months.

Table TR

Turkey: Selected Economic Indicators

	2003	2004	2005	2006	2007	2008 1)	2009	2010	2011
								Forecast	
Population, th pers., average 2)	70231	71152	72065	72971	73436	74414	.	.	.
Gross domestic product, TRY bn, nom.	454.8	559.0	648.9	758.4	853.6	960	1010	1090	1180
annual change in % (real)	5.3	9.4	8.4	6.9	4.6	1.5	-2.5	1	3
GDP/capita (EUR at exchange rate)	3800	4400	5400	5700	6500	7400	.	.	.
GDP/capita (EUR at PPP - wiiw)	7100	8200	9100	10100	10800	10900	.	.	.
Consumption of households,TRY bn, nom.	324.016	398.6	465.4	534.8	604.7	.	.	.	.
annual change in % (real)	10.2	11.0	7.9	4.6	4.1	2	-2	0.3	1
Gross fixed capital form., TRY bn, nom.	77.367	113.7	136.5	169.0	184.1	.	.	.	.
annual change in % (real)	14.2	28.4	17.4	13.3	5.5	-3	-11	4	7
Gross industrial production									
annual change in % (real)	8.7	9.8	5.4	5.8	5.4	-2.3	-15	2	5
Gross agricultural production									
annual change in % (real)	-2.2	2.7	6.6	1.3	-7.3	.	.	.	.
Construction industry									
annual change in % (real)	-9.0	4.6	21.5	.	.	.	.	.	.
Employed persons - LFS, th, avg. 3)	21147	21791	22046	22330	21207	21500	.	.	.
annual change in %	-1.0	3.0	1.2	1.3	1.1	1.5			
Unemployed persons - LFS, th, average 3)	2493	2498	2520	2446	2323	2630	.	.	.
Unemployment rate - LFS, in %, average	10.5	10.3	10.3	9.9	9.9	11.0	13	13	12
Reg. unemployment rate, in %, average	2.5	.	.	.	.	.	.	.	.
Average gross monthly wages, manuf.ind., TRY 4)	.	1030	1162	1301	1437	1590	.	.	.
annual change in % (real) 4)	-1.9	.	4.3	2.1	1.6	0	.	.	.
Consumer prices, % p.a.	25.3	10.6	8.2	9.6	8.8	10.4	8	7	5
Producer prices in industry, % p.a.	.	12.2	7.1	9.7	6.0	13.0	.	.	.
General governm. budget, EU-def., % GDP 5)									
Revenues	.	.	.	20.2	18.3	18.3	.	.	.
Expenditures	.	.	.	20.3	19.6	19.6	.	.	.
Deficit (-) / surplus (+)	.	-4.5	-0.6	-0.1	-1.2	-1.3	-2.5	-2	-1.5
Public debt, EU-def., in % of GDP 5)	67.3	59.2	52.3	46.1	38.9	35.1	.	.	.
Discount rate of NB % p.a., end of period 6)	31.0	22.0	17.5	22.5	20.0	17.5	.	.	.
Current account, EUR mn	-7083	-12482	-17800	-25469	-27457	-26000	-16000	-15000	-15000
Current account in % of GDP	-2.6	-4.0	-4.6	-6.1	-5.8	-4.7	-3.6	-3.3	-3.1
Exports of goods, BOP, EUR mn	45183	53889	63157	74397	84003	97000	90000	93000	102000
annual change in %	6.6	19.3	17.2	17.8	12.9	15	-7	3	10
Imports of goods, BOP, EUR mn	57504	73102	89829	106978	117958	129500	115000	116000	125000
annual change in %	15.0	27.1	22.9	19.1	10.3	10	-11	1	8
Exports of services, BOP, EUR mn	15881	18531	21597	20045	20994	23000	22000	22500	24000
annual growth rate in %	5.1	16.7	16.5	-7.2	4.7	10	-4	2	7
Imports of services, BOP, EUR mn	6617	8165	9180	9125	10893	11500	11000	11000	12000
annual growth rate in %	-4.4	23.4	12.4	-0.6	19.4	6	-4	0	9
FDI inflow, EUR mn	1537	2328	8289	15916	16412	11000	.	.	.
FDI outflow, EUR mn	439	693	863	713	1568	1620	.	.	.
Gross reserves of CB, excl. gold, EUR mn	26616	26436	42823	46251	49804	51157	.	.	.
Gross external debt, EUR mn	114139	117932	142774	155775	167869	207888	.	.	.
Gross external debt in % of GDP	44.5	38.7	35.0	38.3	33.8	46.5	.	.	.
Average exchange rate TRY/EUR	1.6949	1.7771	1.6771	1.8090	1.7891	1.7498	2.3	2.4	2.4
Purchasing power parity TRY/EUR	0.9149	0.9637	0.9917	1.0332	1.0732	1.1833	.	.	.

Note: The term 'industry' refers to NACE classification C+D+E.

1) Preliminary and wiiw estimates. - 2) SIS projections. 2007 figure: Eurostat. SIS figure 2007 (end of year): 70586 th. persons based on new census methodology. - 3) From 2007 according to census 2006. - 4) From 2004 including overtime payment. - 5) According to ESA'95 excessive deficit procedure. - 6) Overnight lending rate.

Source: National statistics (Central Bank, State Institute for Statistics etc). Forecasts by wiiw.